INCOME TAXES ILLUSTRATED

A VISUAL GUIDE TO INCOME IN AMERICA AND HOW IT IS TAXED
Every year, as April approaches, Americans spend hours filing their income tax returns. As a result, most adult Americans are somewhat familiar with how the individual income tax works. In fact, the income tax code is one of the only parts of federal law that almost every American has dealt with personally.

But filling out a tax return offers only a small glimpse of the entire federal income tax system. The individual income tax creates economic and social consequences larger than any single tax return can reflect.

In order for taxpayers to comprehend these consequences, the income tax needs to be examined from several angles: as a source of federal revenue, a tool for social welfare spending, a set of economic incentives, and a subject of policy debates.

Understanding the income tax also requires context. Income in America looks different today than a few decades ago, due to demographic and economic forces. In addition, the federal income tax should be understood against the backdrop of the federal tax system as a whole and in comparison with income taxes around the world.

This book is your visual guide to these different ways of understanding the federal income tax. In over 40 charts, we lay out a picture of income in America and of the income tax’s economic and fiscal effects. In addition, this book provides background on some of the key issues of the tax reform debate. How progressive is the federal income tax? How does it affect decisions about work, saving, and marriage? What is its effect on the U.S. economy? This book provides insight into each of these questions and several more.

As tax reform becomes an increasingly important national topic of discussion, our hope is to arm citizens and lawmakers with the facts necessary for an honest and productive debate.

These charts were created and compiled by Analyst Scott Greenberg, in collaboration with Tax Foundation staff.
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Today, the individual income tax is the single most important source of federal revenue, but it wasn’t always that way. In 1936, excise taxes, such as tobacco and alcohol taxes, brought in more money than any other revenue source. Then, in 1943, the corporate income tax briefly became the most important source of federal revenue.

But since the end of World War II, the story of American tax policy has been the rising importance of taxes on individual income. Today, 47 percent of all federal revenue comes from the individual income tax, while payroll taxes account for another 33 percent.

As the individual income tax has become more important, it has also grown more complicated. In the last 50 years, the length of the tax code and associated regulations has almost tripled. Individual taxpayers now spend billions of hours every year complying with income tax filing requirements.

The most important cause of the complexity of the income tax is the ever-growing tangle of credits, deductions, and other special provisions in the tax code. Justified or not, these credits and deductions reduce Americans’ tax payments by over $1 trillion every year.

So, the individual income tax is both very important and poorly designed. It is this combination that makes the income tax such a promising target for reform.
Almost Half of Federal Revenue Comes from Individual Income Taxes

Composition of Federal Revenue (Billions of Dollars, 2015, Estimated)

- **Individual Income Taxes**: $1,503 billion
- **Payroll Taxes**: $1,056 billion
- **Corporate Income Taxes**: $328 billion
- **Excise Taxes**: $96 billion
- **Estate & Gift Taxes**: $20 billion
- **Other**: $169 billion

Eight out of every 10 dollars that the federal government collects come from just two sources: individual income taxes and payroll taxes. Individual income taxes are paid by households each April, while payroll taxes are removed automatically from employees’ paychecks. Together, these taxes raise $2.5 trillion every year. The other three major sources of federal revenue—corporate income taxes, excise taxes, and estate taxes—are much less significant, raising only about $440 billion. Besides taxes, the federal government also collects a small amount of money from fines, fees, tariffs on overseas trade, and the income of the Federal Reserve.

In 2015, 47.4 percent of federal revenue came from individual income taxes, for a total of $1.5 trillion.

Between 1935 and 2015, the individual income tax has risen from 14.6 percent of federal revenue to 46.2 percent. Individual income tax collections are set to rise even further over the next five years.

Sources of federal revenue have changed dramatically over the last 80 years. Payroll taxes have become increasingly important, due to the creation of Social Security in the 1930s and Medicare and Medicaid in the 1960s. Corporate income taxes have declined as a source of revenue, from 35.8 percent of federal revenue in 1945 to 10.8 percent today. In part, this is because more business income is now taxed on individual tax returns, rather than corporate returns. Excise taxes, such as alcohol and tobacco taxes, which once accounted for over a third of federal revenues, now only make up 3 percent.

Source: Office of Management and Budget, Historical Tables, Table 2.2 (2015).
Where Do Americans’ Tax Dollars Go?


Once federal taxes are collected, they are used to pay for a variety of federal spending programs, ranging from Air Force fighter jets to health insurance subsidies. In 2015, the federal government spent 68 percent of its budget on “mandatory” spending programs, such as Social Security, Medicare, and interest payments on the debt. This means that only one out of three dollars of federal spending goes through the Congressional appropriations process each year; the majority of the budget is on “autopilot.” Some of the spending programs that Congress does budget for each year include military spending and income security programs.

8.9 percent of the federal budget goes to “everything else,” which includes spending on education, agriculture, transportation, housing, and foreign affairs.

Note: “Income security” includes SNAP, unemployment compensation, federal employee pensions, housing assistance, and other income security programs.

Source: Office of Management and Budget, Historical Tables, Table 3.2 (2015).
There are over 10 million words of tax statutes and regulations.


Over the last 60 years, the U.S. tax code has grown drastically in size and complexity. Today, the tax code and tax regulations are seven times longer than they were in 1955, growing from 1.4 million words to over 10 million. This complexity creates real costs for taxpayers: every year, Americans spend over six billion hours complying with tax filing requirements, and over 55 percent of taxpayers now hire professional tax preparers. Overall, tax compliance costs the U.S. economy over $150 billion a year.

In 2014, the federal tax code contained 2.4 million words, while federal tax regulations were 7.6 million words long. At an average reading speed, it would take five weeks to read both, if one did not sleep, eat, or comprehend any of it.

Note: Figures from the West Publishing Company were first obtained for a 2005 Tax Foundation report: The Rising Cost of Complying with the Federal Income Tax. 2015 figures have been adjusted downward from a simple word count of the tax and regulatory codes, in order to avoid measuring the length of appendices, tables of contents, references, etc.

In 2015, the ten largest individual tax expenditures are expected to reduce federal revenue by $784 billion, more than the entire defense budget.

Much of the complexity in the federal tax code comes from tax expenditures—over 150 deductions, credits, and other provisions that reduce people’s tax burdens from what they would owe under a simple income tax. For example, the federal tax code does not treat health insurance provided by employers as income, even though it is a significant portion of worker compensation. If this compensation were taxed at normal rates, the federal government could raise over $206.4 billion in revenue each year. Most tax expenditures are simply subsidies for favored industries and activities—but some, such as the exemption for 401(k) plans and low rates on capital gains, properly protect savings and investment from double taxation.

# The Basics of the Individual Income Tax

## Tax Rates, Brackets, and Parameters (2015)

### Tax Brackets in 2015

<table>
<thead>
<tr>
<th>Single Filers</th>
<th>Married Joint Filers</th>
<th>Head of Household Filers</th>
<th>Rate on Ordinary Income</th>
<th>Rate on Long-Term Capital Gains &amp; Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $9,225</td>
<td>$0 to $18,450</td>
<td>$0 to $13,150</td>
<td>10%</td>
<td>0%</td>
</tr>
<tr>
<td>$9,225 to $37,450</td>
<td>$18,450 to $74,900</td>
<td>$13,150 to $50,200</td>
<td>15%</td>
<td>0%</td>
</tr>
<tr>
<td>$37,450 to $90,750</td>
<td>$74,900 to $151,200</td>
<td>$50,200 to $129,600</td>
<td>25%</td>
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<tr>
<td>$413,200+</td>
<td>$464,850+</td>
<td>$439,000+</td>
<td>39.6%</td>
<td>20%</td>
</tr>
</tbody>
</table>

### Standard Deduction

- **Single Filers**: $6,300
- **Married Joint Filers**: $12,600
- **Head of Household Filers**: $9,250

% of Households Claiming the Standard Deduction, 2014: 68.5%

### Personal Exemption

- **$4,000**

### Maximum Earned Income Tax Credit

- **No Children**: $503
- **One Child**: $3,359
- **Two Children**: $5,548
- **Three or More Children**: $6,242

CHAPTER 2
The Story of Income in America

It is difficult to understand the federal income tax without looking at income in America, where it comes from, and who earns it.

Over the past 50 years, the United States has experienced large-scale demographic and social shifts, which have changed the face of income in America. The Baby Boomer generation has begun to retire, marriage rates have declined, and workers are more likely to be paid in benefits.

Because of these changes, the distribution of income in America looks different today than 50 years ago—more concentrated among the elderly and two-earner couples, and less likely to be paid in wages and salaries.

Of course, another important shift in America’s distribution of income has been the rising levels of income inequality since the 1970s. The story of income inequality is more complicated than usually presented, because of several issues with the measurement of income. Meanwhile, other measures, such as consumption inequality, tell different stories altogether.

But even though income in America has changed over time, some aspects of income remain exactly the same. There are still two basic ways to make income: through work and investment. Workers continue to make around 72 percent of national income in wages and salaries, as they have for the last 80 years. And, according to the best evidence, it remains just as possible today as it was 40 years ago for each new generation to move up and down the income ladder, earning different levels of income than their parents.
For Americans making between $50,000 and $100,000, wages and salaries account for 70.5 percent of their income. Among Americans making over $1 million, wages and salaries only comprise 29.1 percent of income.

Generally speaking, there are two ways for individuals to earn income in any economy: labor and investments. Most Americans making under $1 million earn the majority of their income through labor, in the form of wages and salaries. These families typically only begin to receive substantial investment income when they retire, through IRAs and pensions. On the other hand, Americans earning over $1 million make 42.6 percent of their income through investments and 24.2 percent from businesses they own and operate.

Note: "Investment income" refers to income from interest, dividends, net capital gains, net sale of assets, estates, trusts, rents, royalties, and farm rentals. "Retirement income" refers to pensions, annuities, IRA distributions, and social security benefits. "Business income" refers to net business income, net partnership and S corporation income, and net farm income. "Other income" refers to all other sources of income and losses reported on tax returns. Percents may not add to 100 due to rounding.

Source: Internal Revenue Service, Statistics of Income, Table 1.4 (2015).
About 72 Percent of National Income Has Historically Been Earned by Labor

Share of Net Private Domestic Income (1929–2014)

Every year since 1929, roughly 72 percent of national income has gone to pay individuals for their labor, while 28 percent has gone to individuals who make capital investments. This is a striking trend: amidst the tumultuous changes of the 20th century—wars, recessions, globalization, and technological advancement—the distribution of national income between labor and capital has remained virtually constant. Though some worry that capital income will increase as a share of the economy in the future (leading to more income for the wealthy), no evidence of this trend has shown up in the data.

In 2014, 70.3 percent of national income went to labor, through wages, salaries, and other worker compensation. The other 29.7 percent went to investors of capital, in the form of rent, dividends, and other investment income.

Note: “Net Private Domestic Income” consists of gross domestic income minus consumption of fixed capital, net taxes on production and imports, and taxes on corporate income. “Labor Income” consists of all compensation of employees. “Capital Income” consists of the net operating surplus of private enterprise before corporate income taxes. Source: Bureau of Economic Analysis, Table 1.10. Gross Domestic Income by Type of Income (2014).
In 2013, the top 20 percent highest-income households earned 48.8 percent of all national income, up from 40.9 percent in 1970.

Over the last few years, conversations about income in the United States have often focused on the topic of income inequality. Beginning in 1970, the gap between rich and poor Americans widened as the wealthiest households started to see their share of national income increase. While every income group is richer today than in 1970, the incomes of the top 20 percent of Americans have grown faster. Several explanations have been proposed to account for this increase in inequality, including globalization, innovations in technology, and changes in federal policy.

In 2013, the highest-earning Americans were those between 55 and 64 years old, who made an average $87,882 in household income. Americans between 26 and 34 only earned an average $43,936 in household income.

Workers Are Increasingly Paid in Forms Other than Wages and Salaries

Composition of Labor Compensation (1929–2014)

Another factor that complicates the conventional story about income inequality is how worker pay has changed over time. Fifty years ago, it was still relatively uncommon to offer workers benefits other than their regular wages and salaries; in 1965, only 10.5 percent of worker compensation was in the form of benefits. Now, almost 20 percent of all worker compensation takes the form of health insurance, 401(k) plans, pensions, and other benefits. Most of these benefits are not captured in government income data, giving the impression that workers are paid less than they actually are.

In 1929, wages and salaries made up 98.1 percent of total worker compensation. By 2014, wages and salaries only accounted for 80.8 percent of worker compensation.

Source: Bureau of Economic Analysis, Table 1.10. Gross Domestic Income by Type of Income (2015).
Between 1960 and 2013, the share of tax returns filed by married households fell from 65.2 percent to 38.5 percent.

Note: "Single" includes taxpayers filing as single and those filing as head of household. "Married" includes married taxpayers filing jointly and those filing separately.

Source: Internal Revenue Service, Statistics of Income, Table 1.2 (2015).
High-Income Households Have More Wage Earners than Low-Income Households

Most measures of income inequality look at how income is distributed among households, rather than among individuals. This leads to some odd results, because income disparities between households often boil down to how many members of the household are earning money. Households with higher incomes tend to include two or more individuals who earn money, while many households with lower incomes contain no wage earners at all. So, even if income were distributed perfectly equally among individuals, household incomes would still look substantially unequal.

54 percent of households making $35,000 had one wage earner. Only 18 percent of households earning $135,000 had one wage earner.

Note: For ease of presentation, household incomes have been rounded up to the nearest $5,000.
Income Is Strongly Linked to Education

Average Annual Income, by Highest Level of Education Attained (2013)

One of the important factors that shapes the distribution of income in America is education. On average, individuals with higher levels of education earn much higher incomes. In particular, bachelor’s degrees are associated with significantly higher income levels. The average annual income for Americans with a bachelor’s degree is $95,042, compared to an annual income of $59,517 for Americans who started college but did not earn a degree. In many ways, America’s income gap is now an education gap, as most high-income households also have high education levels.


Americans with master’s degrees earn, on average, over three times the income of Americans who have not graduated from high school.
While most discussions of inequality in America center around income inequality, other measures of inequality tell slightly different stories. In particular, the amount that households consume in the United States is distributed much more equally than income is. While the lowest-income Americans earned only 3.6 percent of national income between July 2013 and June 2014, they accounted for 8.8 percent of all consumption. One explanation for why consumption inequality is lower than income inequality is that, while incomes swing up and down from year to year, household consumption stays relatively steady.

The 20 percent highest-income Americans receive 47.8 percent of national income but only account for 38.9 percent of national consumption.

Note: Income statistics differ slightly from those presented earlier, from the Current Population Survey. Quintiles consist of consumer units, sorted by before-tax income. Consumption inequality figures may inaccurately capture durable goods consumption. For more information, see Hassett and Mathur (2012).

The United States Has Considerable Income Mobility

Percentage of Americans in Each Income Quintile, by Parent’s Income Quintile (2014)

In addition to inequality, many voters are concerned about income mobility: the chances for each new generation to move up or down the income ladder from where they were born. The evidence is clear that, although family income at birth has some effect on income in adulthood, most Americans do not end up in the same income group in which they were born. For instance, a child born into the middle-income quintile has a 17.78 percent chance of ending up in the lowest quintile and a 18.25 percent chance of ending up in the highest. The data also shows that, although income inequality has increased since the 1970s, relative income mobility remains as high today as it was 40 years ago.

A child born in the lowest income group has a 66.32 percent chance of moving out of that group by adulthood. A child born in the highest income group has a 63.48 percent chance of ending up in a lower one.

Note: Percents may not add to 100 due to rounding.

CHAPTER 3
Who Pays Taxes?

Much of the debate about the federal income tax revolves around the question of who should pay taxes—whether to raise rates on rich Americans, use the tax code to help low-income households, or lower the tax burden on the middle class. Yet, often missing from these debates is a sense of how much different groups of Americans actually pay in taxes currently.

The federal income tax is progressive: it imposes higher rates on individuals with higher incomes. For example, the top 1 percent highest-earning Americans pay over twice the average income tax rate of the other 99 percent of taxpayers. Even though not all federal taxes are as progressive as the income tax, the federal tax system as a whole remains quite progressive, with households earning over $1 million paying 33.1 percent of their income in taxes.

As a result, the operations of the federal government are largely funded by taxes on wealthy Americans. Almost half of federal revenues come from households making over $200,000. Meanwhile, in 2012, the lower-income half of American taxpayers only paid 2.8 percent of all federal income taxes.

Of course, taxes are only part of the picture. Government transfer programs, such as food stamps and Medicaid, significantly increase the share of national income held by the poorest households. Low-income Americans benefit extensively from these programs, receiving over $8 in federal benefits for every $1 they pay in taxes.

There are many definitions of what a “fair” tax system looks like, but debates about how to make America’s tax system fair should always be grounded in the facts about who pays taxes.
A tax is progressive if it imposes higher rates on individuals with higher incomes. Several features of the federal income tax make it a progressive tax, including many provisions targeted at easing the tax burden for low-income individuals. In fact, households with incomes less than $40,000 typically end up receiving additional income through the tax code, due to refundable credits like the Earned Income Tax Credit. For instance, households making between $10,000 and $20,000 face an income tax rate of negative 11 percent, which means that they receive $11 through the income tax code for every $100 they make.

Households making over $1 million in 2015 will pay 27.4 percent of their incomes in income taxes, more than twice the average income tax rate of 10.1 percent.

Note: Figures are projected. Income groups are not adjusted for household size. Source: Joint Committee on Taxation, Fairness and Tax Policy (2015).
High-Income Taxpayers Pay an Increasing Share of Income Taxes


Over the last 30 years, high-income households have become responsible for more of the income tax burden. The 10 percent highest-income taxpayers now pay 69.8 percent of all income taxes, up from 54.7 percent in 1986. This trend has been largely driven by the growing incomes of the richest Americans, as well as the expansion of tax credits aimed at low-income Americans. Since 2003, the top 1 percent of taxpayers have paid a greater share of federal income taxes than the bottom 90 percent combined.

The top 1 percent of taxpayers pay 37.8 percent of all income taxes. The bottom 50 percent of taxpayers pay only 2.8 percent of all income taxes.

The average income tax rate for the top 1 percent highest-income households has fluctuated significantly since 1986, rising in 2013 to 27 percent.

Although there is extensive public discussion of whether the individual income tax should be more progressive or less so, it is indisputable that the current system is progressive; the top 1 percent highest-earning taxpayers pay much more in income taxes than most Americans, even after credits and deductions. In 2013, the top 1 percent of taxpayers paid an average income tax rate of 27.1 percent, while all other Americans paid an average income tax rate of 10.5 percent. The total income tax burden of the top 1 percent of taxpayers in 2013 was $466 billion, 38 percent of all income taxes paid.

Households making less than $100,000 typically pay far less than the average federal tax rate of 21.0 percent. Those making over $1 million pay an average tax rate of 33.1 percent.

Note: Figures are projected. Income groups are not adjusted for household size.
Almost Half of Federal Revenues Come from Households Making over $200,000

Share of Total Income and of All Federal Taxes, by Income Group (2015, Projected)

When all federal taxes are taken into account, the federal government relies on high-income households for most of its revenue. These households earn a large share of all income, but pay an even larger share of all federal taxes. Households making more than $1 million earn 13.7 percent of all income but pay 21.6 percent of total taxes. On the flipside, while households earning less than $100,000 make 38.8 percent of all income, they pay only 23.3 percent of federal taxes. In this way, most low-income households face a much smaller tax burden than average.

Households that make more than $200,000 earn 34.5 percent of national income, but pay 49.3 percent of all federal taxes.

Note: Figures are projected. Income groups are not adjusted for household size. Percents may not add to 100 due to rounding.
Federal Taxes and Transfers Redistribute a Substantial Amount of Income

Share of Income before and after Federal Taxes and Transfers, by Quintile (2012)

While the federal government relies on high-income households for most of its revenue, much of federal spending is directed at low-income Americans. Programs such as SNAP (food stamps), TANF (cash assistance), and Medicaid (health insurance) are designed to transfer money and other benefits to low-income households. All together, the federal system of taxes and welfare programs redistributes a considerable portion of national income. In 2012, the 20 percent lowest-income households earned 3.1 percent of national income. After federal taxes and government transfer programs, their share of national income was raised to 9.9 percent.

Taxes and transfer programs reduced the earnings of the 20 percent highest-income households from 54.7 percent of national income to 43.2 percent.

Low-Income Americans See the Most Benefits for Each Dollar Paid in Federal Taxes

Federal Spending Received per Dollar Paid in Federal Taxes, by Income Group (2012)

Low-income Americans benefit most from the federal system of taxes and transfers, because they pay relatively low taxes but receive a large share of government spending. For every dollar that the 20 percent lowest-income Americans pay in federal taxes, they receive $8.13 in federal spending. On the flip side, high-income Americans bear most of the cost of the federal government and receive only a limited portion of federal spending. The 20 percent highest-income American households receive only $0.25 in federal spending for every dollar they pay in federal taxes.

For every $1.00 that the middle income quintile of Americans pay in federal taxes, they receive $1.59 in federal spending.

CHAPTER 4
What Incentives Does the Income Tax Create?

Taxes change people’s behavior. Every day, individuals and businesses make decisions about work and investment by weighing costs and benefits. Even slight changes in the tax code can shift the balance, altering the incentives that taxpayers face and changing how they participate in the economy.

Some of these incentives can be harmful to American families. For families in poverty, switching to a higher-paying job often means receiving less federal assistance, making it difficult for low-income individuals to increase their incomes through working. Then, as soon as these households move out of poverty, their tax burdens begin to increase very rapidly, making additional work less profitable.

The income tax code also gives strong incentives for households to consume, rather than save. Investment income, such as capital gains and dividends, faces two levels of taxation under U.S. law, leading Americans to save and invest less.

Unfortunately, many of the incentives that the U.S. tax code creates are complex and confusing. A family of four may face up to eight different tax rates on the first $50,000 it earns, ranging from negative 47 percent to positive 44 percent. And a couple considering marriage might receive a large tax bonus for marrying, or a significant penalty, depending on their incomes and the number of children they have.

Because the tax code affects practically every aspect of American society, it is essential to understand the incentives it creates for individuals and families.
A Family’s Tax Burden Begins to Increase Rapidly once Its Income Exceeds the Poverty Line

Income and Payroll Tax Liability for a Married Household with Two Children, by Income Level (2015)

Because the U.S. tax system is designed to transfer money to low-income families, the typical household making under $40,000 faces a negative tax burden: it pays less money in taxes than it receives through the tax code, in the form of a refund. This is mostly due to refundable tax credits, such as the Earned Income Tax Credit (EITC). However, the EITC is designed so that it phases out for families earning above the federal poverty line. As the EITC phases out, each additional dollar a household makes leads to a smaller refund and a higher tax burden. Because of this, once a household crosses the federal poverty line, its tax burden begins to increase rapidly.

Once a four-person household's income hits $23,630, the Earned Income Tax Credit begins to phase out, and its tax burden starts to rise quickly.

Note: The calculations apply for a married couple, filing jointly, with two children, whose only income source is wage earnings. The household is assumed to receive the Child Tax Credit and Earned Income Tax Credit, and no other tax credits.

Source: Tax Foundation calculations. Poverty threshold data is from the Census Bureau (2014).
Working Class American Families Face Marginal Tax Rates up to 43.7 Percent

Implicit Marginal Income and Payroll Tax Rates for a Married Household with Two Children (2015)

One of the most important features of any tax code is the marginal tax rates, which measure how quickly a household’s tax burden grows with each additional dollar it makes. Usually, a household’s marginal tax rate is the same as the rate of whatever income tax bracket it falls into, plus the payroll tax rate. However, for households making between $23,500 and $50,000, the phase-out of the Earned Income Tax Credit creates marginal tax rates as high as 43.7 percent—higher than the top income tax bracket. With such high marginal tax rates, it is expensive for households making between $23,500 and $50,000 to increase their work hours or move to higher-paying jobs.

A family of four making $48,000 sees its tax burden increase by 43.7 cents for the next dollar it makes.

Note: The calculations apply for a married couple, filing jointly, with two children, whose only income source is wage earnings. The household is assumed to receive the Child Tax Credit and Earned Income Tax Credit, and no other tax credits.

As low-income households earn more money, not only do their tax burdens grow rapidly, but they also receive fewer benefits from federal social assistance programs. In fact, individuals who move to higher-paying jobs sometimes end up with less overall disposable income, after taxes and transfers. In this way, the federal system of taxes and benefits distorts individuals’ work decisions, making it more difficult for low-income individuals to increase their incomes through the labor market.

A typical single parent with one child could earn $16,200 more in wages and only see $1,967 more in additional take-home income, because of higher taxes and fewer federal benefits.

Note: Take-home income is income after taxes and transfers. The data in this chart accounts for federal and state individual income taxes, federal payroll taxes, TANF, Medicaid, SNAP, CHIP, and Housing Vouchers for a typical Pennsylvania resident. Source: Congressional Budget Office, Effective Marginal Tax Rates for Low- and Moderate-Income Workers (2012).
A hypothetical family of four making more than $485,000 in labor income pays a tax rate of 41.2 percent on each additional dollar it earns.

While the effects of the tax code on labor earnings are most noticeable for individuals just above the poverty line, American workers of all income levels can face a substantial tax burden on their added work effort. Almost all U.S. households making over $100,000 face tax rates of over 30 percent on each additional dollar they earn. These high rates almost certainly affect decisions about work and employment among workers on the margin; they also influence the investment decisions of entrepreneurs and small business owners, who pay individual income taxes on their business earnings.

The tax code also affects decisions about household saving. The U.S. tax code gives taxpayers strong incentives to spend their income immediately, rather than saving it. After taxes, a single taxpayer earning $100,000 has 81.8 percent of her income free to spend on consumption. But if the taxpayer chose instead to put her income into savings for 20 years, she would only be left with 72.7 percent of her income available to be used for consumption. This is because income from saving—such as capital gains and dividends—is subject to a second level of federal taxation, which makes saving less desirable.

American taxpayers who choose to save their money, rather than consume, face two levels of taxation: when the money is earned and after it is withdrawn from saving.

Note: This chart assumes a single taxpayer, earning a $100,000 salary and taking the standard deduction. This assumes a 7 percent annual rate of return on investment, a 7 percent annual discount rate, and a tax rate of 15 percent on capital gains at the end of the period. This chart does not account for tax-free savings accounts. Source: Tax Foundation calculations (2015).
Not only does the tax code affect decisions about work and saving, but it also creates a complex and confusing set of incentives for individuals who are considering marriage. Two individuals with no children can receive a tax bonus of up to 7 percent or face a tax penalty of up to 4.3 percent of their income for marrying. The tax bonus or penalty from marriage depends on the couple’s combined income, as well as how evenly the income is split between the two spouses. The tax code tends to treat single-earner households more favorably, while penalizing spouses with similar income levels.

For two individuals without children, one of whom earns $75,000 and one of whom earns $25,000, getting married would save the couple roughly $2,500 in taxes (as indicated by the arrows on the diagram).

Note: This chart models the effects of the individual income tax, the Earned Income Tax Credit, the Alternative Minimum Tax, payroll taxes, standard deductions and personal exemptions (and their phase-out), and all three filing statuses (single, married, and head of household).


The Tax Code Creates a Complicated Set of Penalties and Bonuses for Marriage

The Increase or Reduction in Tax Burden for Two Individuals Who Marry (2015)
Overall, the United States collects less in taxes than other developed nations. Among the 34 countries in the Organisation of Economic Co-Operation and Development (OECD), only two countries raise less tax revenue than the United States as a share of their economies.

However, even though the U.S. has lower taxes on average than other countries, the U.S. tax system is structured differently than those of most developed nations. The U.S. relies heavily on taxes on income, while other countries tend to tax the consumption of goods and services instead.

As a result, the United States actually has some of the highest tax rates in the developed world when it comes to investment income—such as capital gains and dividends. Many countries do not impose any taxes on capital gains, so as not to add a second layer of taxation on investment. The U.S., on the other hand, has the sixth highest tax rate on capital gains among developed nations and the ninth highest rate on dividends.

While the U.S. generally has high taxes on investment, it taxes workers less than most of the developed world. Between federal, state, and local income and payroll taxes, the U.S. imposes an average combined tax rate of 31.5 percent on labor, the 10th lowest rate among developed countries. However, when it comes to high-income workers, the U.S. levies higher top marginal tax rates than other developed countries, one sign that the U.S. tax code is relatively progressive compared to other developed nations.

As the U.S. moves toward comprehensive tax reform, it will be useful to keep the tax systems of other developed nations in mind, as a source of context and comparison.
Most other developed nations bring in much higher levels of tax revenue than the United States does. The average member country of the OECD collects 33.7 percent of GDP in tax revenues, while U.S. federal, state, and local governments collect 24.4 percent of GDP in taxes. Only two countries, Chile and Mexico, collect less in taxes, as a portion of their economies, than the U.S. does. Other countries, such as Denmark, collect almost double the level of tax revenue that the U.S. does, in order to fund governments that are significantly bigger than that of the U.S.

The Organisation for Economic Co-Operation and Development (OECD) is a group of 34 developed countries, which often serve as a useful comparison to the United States.
In 2012, individual income taxes made up 37.7 percent of U.S. federal, state, and local tax revenues. For the OECD at large, income taxes comprised only 24.5 percent of revenues, on average.

One area of the U.S. tax code that imposes a higher tax burden than most other developed nations is the taxation of capital gains. When a U.S. household sells an investment, a home, or another asset for a profit, it is required to pay rates of up to 28.6 percent on the capital gain. The U.S. top tax rate on capital gains is the sixth highest in the developed world, placing a large burden on Americans who save and invest. Meanwhile, nine developed countries do not tax capital gains at all.

While the average top marginal tax rate on capital gains in developed countries is 18.4 percent, the U.S. top marginal rate is over 10 points higher, at 28.6 percent.

Source: Ernst and Young; Deloitte; Tax Foundation calculations (2015).
Another area of the U.S. tax code that has higher rates than most of the developed world is the taxation of dividends. When a corporation distributes its profits to U.S. shareholders as dividends, the shareholders are taxed at rates up to 28.6 percent on their dividend income. Taxes on dividends represent a second layer of taxation on corporate profits, which are first subject to corporate income taxes. The U.S. top tax rate on dividends is higher than that of 25 other developed countries, two of which do not tax dividend income at all.

The U.S. top marginal tax rate on personal dividend income is the ninth highest among developed countries.

Source: OECD Statistics; Ernst and Young; Tax Foundation calculations (2015).
The Average Tax Burden on Labor in the U.S. is Lower than in the OECD

**Average Combined Taxes on Labor, the U.S. and OECD (2014)**

In contrast to the U.S.’s high rates on capital gains and dividends, the U.S. tax burden on labor is decidedly lower than average for the developed world. American workers are subject to multiple taxes on their labor income: both payroll and income taxes, at the federal, state, and local levels. In 2014, due to all of these taxes combined, U.S. workers saw their labor income lowered by 31.5 percent, on average. This combined rate on labor income is the tenth lowest among developed nations.

The average U.S. tax burden on labor income is 31.5 percent, over four points lower than the OECD average rate of 36.0 percent.

The Top Marginal Tax Rate on Labor Is Higher in the U.S. than in the OECD

Top Marginal Tax Rates on Income, the U.S. and OECD (2014)

While the U.S. imposes a lower average tax burden on labor income than the rest of the developed world, the U.S. still levies higher marginal tax rates on labor than many other nations. When taking into account federal, state, and local income and payroll taxes, the top marginal tax rate on labor income in the United States is 48.6 percent. This is one indication that the U.S. tax code is more progressive compared to other nations: it imposes higher-than-average rates on the wealthiest while collecting a lower-than-average burden overall.

The top marginal tax rate on labor income in the U.S. is 48.6 percent, higher than the average top marginal rate for developed countries, of 46.3 percent.

What Would Happen if We Fixed the Tax Code?

Almost everyone agrees that the current U.S. tax code is complex, inefficient, and unsound. The individual income tax, in particular, contains dozens of credits, deductions, and exclusions that benefit narrow interests, don’t always make sense, distort the economy in numerous ways, and reduce federal revenue by billions of dollars every year.

Meanwhile, the U.S. economy remains sluggish, and saving and investment are in a long-term decline. So, many politicians have turned to tax reform as an opportunity to spark economic growth and improve Americans’ lives.

One of the easiest ways to bring about economic growth through the individual income tax code is simply to lower rates. Lower tax rates make work and investment more profitable, giving households the incentives to grow the nation’s economy. In particular, lower taxes on investment would help expand America’s economic infrastructure, contributing to long-term growth.

Of course, lowering tax rates would increase the federal deficit. One way to reduce the deficit effects of lower tax rates is by eliminating or limiting some of the expensive, narrowly-targeted provisions in the tax code, such as the mortgage interest deduction or the deduction for state and local taxes. This strategy—of lower rates and a broader tax base—is the most promising path to tax reform.

Fixing the tax code isn’t just about making filing season easier for American families; it’s also about insuring America’s long-term prosperity.
Individual Tax Rate Cuts Would Grow the Economy


Because individual income taxes influence decisions about work and investment, changing the income tax rate can affect economic growth. Currently, ordinary income (such as wages and salaries) is taxed at a top rate of 39.6 percent. Raising the top tax rate to 60 percent would bring in significantly more federal revenue, but would shrink the economy by 2 percent, due mostly to an increased burden on pass-through business income. On the other hand, lowering the top tax rate to 15 percent would grow the economy by 3.3 percent, even though doing so would lead to lower federal revenue.

Cutting the top tax rate on ordinary income to 25 percent would grow the economy by 1.3 percent. Doing so would cost the government $102 billion a year, or 2.6 percent of total federal revenue.

Lowering Investment Taxes Would Lead to More Economic Growth, with Less Revenue Loss

Economic and Revenue Effects of Changing Top Tax Rates on Capital Gains and Dividends (2015)

Many economists believe that long-term growth is driven by investment. As a result, taxes on capital gains and dividends are particularly harmful for economic growth, because they make it more difficult to invest. Currently, the top federal tax rate on capital gains and dividends is 23.8 percent, in addition to several other layers of taxation on savings and investment. Raising the top tax rate on capital gains and dividends to 40 percent would only increase federal revenue by 1.2 percent, because of the negative effects on long-term economic growth that would result.

Eliminating taxes on capital gains and dividends would grow the economy by 3.29 percent. This would cost the federal government $138 billion a year, or 3.56 percent of its revenue.

Some Tax Cuts Produce More Growth than Others

Comparison of Economic Effects of Four Equally Expensive Tax Cuts (2015)

No two tax cuts impact the economy in the same way. All four tax cuts shown in the graph would reduce federal revenue by $670 billion over 10 years. However, some would lead to more economic growth than others. Doubling the Child Tax Credit to $2,000 would not significantly affect individuals’ incentives to work and invest, and would only produce minimal growth. Cutting the rate of the lowest income tax bracket would reduce the cost of labor and grow the economy by 0.15 percent. Cutting the rate of the top income bracket would grow the economy by 0.65 percent. Finally, cutting tax rates on capital gains and dividends would encourage investment and lead to 1.13 percent growth.

Reducing the top rate on capital gains to 14.7 percent from 23.8 percent would cause over 20 times as much economic growth as doubling the Child Tax Credit, for the same cost.

Corporate Tax Rate Cuts Would Grow the Economy More than Individual Rate Cuts

Comparison of Economic and Revenue Effects of Selected Tax Cuts (2015)

While cutting individual income tax rates would help grow the economy, cutting the corporate tax rate would be even more effective at creating growth. This is because only about a third of the burden of the individual income tax falls on investment, while almost the entire burden of the corporate income tax falls on investment. Lowering the top individual tax rate to 25 percent would grow the economy by 1.29 percent, while cutting the corporate top rate to 25 percent would grow the economy by 2.29 percent.

Cutting both the top individual income tax rate and the top corporate income tax rate to 25 percent would grow the economy by 3.66 percent.

Ending the Deduction for State and Local Taxes Would Raise Significant Revenue

Economic Effects of Eliminating the State and Local Tax Deduction (2015)

Tax rate cuts are expensive for the federal government, and politicians often propose paying for rate cuts by eliminating or limiting itemized deductions. One of the most significant itemized deductions is the deduction for state and local taxes paid, which cost the federal government almost $81 billion in 2015. This deduction largely benefits households in high-tax states, such as New Jersey and California. Eliminating the state and local tax deduction would lead to a higher tax burden on work and investment, decreasing the size of the economy by 0.22 percent. However, if the revenues from eliminating the state and local tax deduction were used to cut the top income tax rate, significant economic growth would result.

Eliminating the deduction for state and local taxes and using the revenues to cut the individual income tax rate would grow the economy by 1.77 percent.

Eliminating the Charitable Deduction Would Have Modest Economic Effects

Economic Effects of Eliminating the Charitable Deduction (2015)

One of the most popular itemized deductions in the tax code is the charitable deduction. There are over one million tax-exempt charitable organizations in the United States, and contributions made to any of these organizations are tax deductible, for individuals who itemize their deductions. Eliminating the charitable deduction would decrease the size of the economy by 0.09 percent, due to the resulting higher tax burden. However, the economy would grow by 0.79 percent if the revenues from eliminating the charitable deduction were used to cut the income tax rate.

In 2016, the deduction for charitable contributions will cost the federal government $58 billion in lost revenue.

Eliminating the Mortgage Interest Deduction and Cutting Rates Would Lead to Economic Growth

Economic Effects of Eliminating the Interest Paid Deduction (2015)

The mortgage interest deduction allows taxpayers who own their homes to deduct up to $1 million of mortgage interest payments. In theory, the mortgage interest deduction prevents housing payments from double taxation; this is why eliminating it would shrink the economy by 0.34 percent. However, in practice, the mortgage interest deduction costs the federal government $75 billion in lost revenue each year and distorts investment toward owner-occupied housing. Eliminating the mortgage interest deduction and using the revenue for an income tax cut would grow the economy by 1.62 percent.

By itself, ending the mortgage interest deduction would shrink the economy by 0.34 percent. But, accompanied with a revenue-neutral rate cut, it would grow the economy by 1.62 percent.

Capping Itemized Deductions Would Raise Significant Revenue with Minimal Economic Harm

Economic Effects of Capping Itemized Deductions at $25,000 (2015)

Capping itemized deductions at $25,000 would bring in $188 billion in additional annual revenues. There are over a dozen itemized deductions available to taxpayers, which are mostly claimed by high-income taxpayers. Some politicians have proposed capping the total amount of itemized deductions that a taxpayer can claim, as a way of simplifying the tax code and raising additional federal revenue. While imposing a cap on itemized deductions would be a significant tax hike, it would decrease the size of the economy by only 0.17 percent. If the revenues were used to pay for a rate cut, the size of the economy would grow by 1.99 percent.

Capping itemized deductions at $25,000 would bring in $188 billion in additional annual revenues.

About the Tax Foundation

The Tax Foundation is the nation’s leading independent tax policy research organization. Since 1937, our principled research, insightful analysis, and engaged experts have informed smarter tax policy at the federal, state, and local levels. Our Center for Federal Tax Policy is routinely relied upon for presentations, media appearances, and reports on federal tax and fiscal policy. Our website is a comprehensive resource for information on the federal tax system.

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Every year, as April approaches, Americans spend hours filing their income tax returns. As a result, most adult Americans are somewhat familiar with how the individual income tax works. In fact, the income tax code is one of the only parts of federal law that almost every American has dealt with personally.

But filling out a tax return offers only a small glimpse of the entire federal income tax system. The individual income tax creates economic and fiscal consequences larger than any single tax return can reflect.